Market Review & Outlook

October 2022

Financial markets continue to be challenged on many fronts as the 3rd quarter ended this past Friday. Indeed, US stocks have broadly declined for three consecutive quarters for the first time since the Great Financial Crisis. Through three quarters, the only years when US stocks suffered larger declines were 1931, 1974, and 2002, all during historically significant bear markets.

A major difference between those episodes and the current predicament is the horrific performance of the 2022 bond market and the state of inflation. Inflation was also a big problem in 1974, but for the most part, bonds posted positive nominal returns that year. Nonetheless, real returns were still negative once you factored in the loss of purchasing power due to inflation. Contrast that with now, when bonds are not only declining in value, but the loss of purchasing power through inflation means those negative nominal returns are even worse in real terms. For a more detailed look at how various asset classes performed in recent periods, please refer to the table above.

Index	Sept 2022	3rd Qtr. Perfomance	YTD Performance	One Year	Description (what the index is comprised of)
S&P 500	-9.21%	-4.88%	-23.87%	-15.47%	Large Cap Stocks
DJ Industrial Average	-8.76%	-6.17%	-19.72%	-13.40%	Large Cap Stocks
NASDAQ Composite	-10.44%	-3.91%	-32.00%	-26.25%	Large & Mid Cap Tech Stocks
Russell 1000 Growth	-9.72%	-3.60%	-30.66%	-22.59%	Large Cap Growth Stocks
Russell 1000 Value	-8.77%	-5.62%	-17.75%	-11.36%	Large Cap Value Stocks
Russell 2000 Growth	-9.00%	0.24%	-29.28%	-29.27%	Small Cap Growth Stocks
Russell 2000 Value	-10.19%	-4.61%	-21.12%	-17.69%	Small Cap Value Stocks
MSCI EAFE	-9.35%	-9.36%	-27.09%	-25.13%	International Stocks
MSCI EM	-11.72%	-11.57%	-27.16%	-28.11%	Emerging Markets Stocks
Credit Suisse High Yield	-3.93%	-0.44%	-13.80%	-13.26%	High Yield Corporate Bonds
Bloomberg Agg. Bond Index	-4.32%	-4.75%	-14.61%	-14.60%	Primarily US Gov't Bonds + Inv. Grade Corporates

The strong rally that took place from mid-June to mid-August faded and this past week, US stock indices closed below the June 16 market low, quashing any hopes those levels represented "the bottom" for the current downturn. Prior to the past few weeks, many professional investors remained optimistic that stocks had bottomed, inflation had peaked, and the Fed would soon pivot back to a more accommodative stance, at least rhetorically. Then, the August US CPI report was released prior to the market open on September 13, showing inflation had increased 8.3% year-over-year, vs. expectations of an 8.1% increase. While the year-over-year rate still declined from 8.5% in July, the report revealed more "stickiness" among core inflation components than anticipated.

In reaction, the S&P 500 fell 4.3%, its worst day in over two years, as investors rightfully perceived that stickier inflation means the Fed must keep tightening monetary conditions as long as inflation remains high. Fed chair Jay Powell's hawkish September 21 speech didn't help matters. While the Fed did increase rates that day by another 0.75% ("in line with market expectations"), Powell gave no hint the Fed would back away from rate hikes over the remainder of the year.

The result was the S&P 500 finished its worst month since March 2020 (i.e., the beginning of the pandemic), and as of the end of the quarter sat 16.7% below the recent August 16 high and 25.25% off its all-time high set on January 3. Other major indices, such as the Nasdaq Composite and small company Russell 2000, have suffered even greater losses from their highs with declines of 33.83% and 31.85%. In addition, interest rates and currencies around the world have been exhibiting historically high volatility, stoking fears that monetary tightening by central banks is going to cause enough dislocation in the global financial system to precipitate a crisis.

An important pain point has been the value of the US dollar, which year-to-date has surged nearly 17% against a basket of foreign currencies, roiling other economies and markets around the world. Recent global shocks – primarily the war in Ukraine – have helped the strength of the dollar, as investors, companies, and other countries often stash their reserves in dollars during tough times. However, the main reason for the strong dollar has been the Fed hiking interest rates to fight high inflation, and given the recent hawkish rhetoric from the Fed, there's no reason to think dollar strength won't continue. To wit, before the Fed and other central banks began to hike rates, the US already had higher interest rates than most developed countries, so US Treasury bonds were arguably more attractive than other sovereign bonds with their higher yields. If global markets continue to weaken, a subsequent flight to safety into Treasuries could further bolster the demand for and the price of dollars.

A big reason for the pain is that most global commodities trade in US dollars because of its status as the world's reserve currency. When the dollar strengthens, commodities become more expensive in other, non-dollar currencies, which tends to have a negative influence on demand. This dynamic has contributed to higher inflation in most overseas markets relative to the US, with August Eurozone inflation tracking at 9.1% vs. 8.3% in the US. This has contributed to a cost-of-living crisis that is playing out across the Eurozone and other countries. For example, in the UK, many businesses are being pushed to the brink by skyrocketing energy bills and are being forced to raise prices. The fact the British Pound has declined against the dollar by nearly 18% year-to-date compounds the problem, as the cost of many goods and services that are imported into the UK go up. Other major currencies, like the Japanese Yen, have experienced similar declines vs. the dollar the magnitude of which are generally only seen with emerging markets currencies.

Bonds have historically been considered a "conservative" asset class, one where investors accept a lower rate of return in exchange for safety and peace of mind. Of course, there are many kinds of bonds, with differing levels of risk, but the government bonds of developed countries and investment grade bonds of large, established corporations have traditionally been considered low-risk investments. Critics will say the US bond benchmark, the Bloomberg Barclays US Aggregate Bond Index, only goes back to 1977, and for most of this 45-year period, interest rates were in a secular downtrend. Consequently, since the prices of bonds move inversely to interest rates, there were only a few years during that period where bonds declined in value, with the worst year being a ~3% decline in the benchmark in 1994. Still, there is bond market data that goes much further back, and while it's clear there were periods when bonds suffered greater than 3% annual losses, the current year is still a large outlier.

Through September 30, global bond markets suffered losses once thought impossible, with the Bloomberg Global Aggregate Bond Index having declined almost 20% YTD. While the index only goes back to 1990, the previous worst annual loss was 5.17% in 1999. The index is priced in dollars, so with 53% of the index denominated in foreign currency, that means when the losses are translated back into a strengthening dollar, they look even worse. That is why the US aggregate bond index (100% dollar-denominated bonds) is doing relatively better than the global aggregate. The 14.6% YTD decline in this index is still setting records, just not to the degree of its global counterpart.

Addressing the recent spike in Treasury yields and volatility in bonds, last week US Treasury Secretary Janet Yellen said, "we haven't seen liquidity problems develop in markets -- we're not seeing, to the best of my knowledge, the kind of deleveraging that could signify some financial stability risks." Based on the lousy forecasting record of US Fed and Treasury officials, we wouldn't put too much stock in this statement. A year ago, the Fed was forecasting inflation would be 2.3% twelve months hence.

The strong dollar doesn't just hurt overseas, it can also have a significant impact on corporate profits for US-based companies. According to Goldman Sachs, almost 30% of S&P 500 revenue comes from overseas, and when companies repatriate those earnings back to the US, they go down when converted back into a strong dollar. Microsoft mentioned this months ago on an earnings call, back before the problem is as acute as it is, and numerous large companies have mentioned the dollar's effect in earnings guidance since. The fact that multinational companies have robust currency hedging programs testifies to the magnitude and speed of these currency moves that they're still having such an impact on corporate financials.

Recent announcements by various market bellwethers, including FedEx's profit warning, Nike's huge inventory build, Apple's production cuts, and Tesla's miss on sales, are foreshadowing a corporate earnings recession that should play out over the remainder of this year and into the first half of 2023. Stocks have rallied strongly during the first two trading days of the year, which is not surprising given how deeply that market was oversold at the end of last week. Unfortunately, we believe the current bear market is still very much alive and that a global recession is likely, if not inevitable. The old Wall Street adage, "don't fight the Fed," applies on the downside as well as the upside.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.